

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

77-6214

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

ROBERT L. VESCO, et al.,

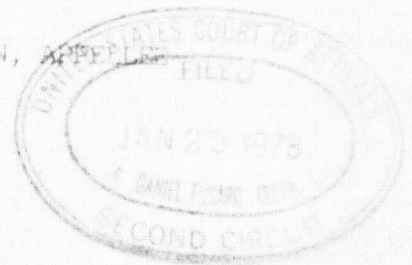
Defendants,

WADE S. MALHAS, et al.,

Intervenors-Appellants.

Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, Appellee



DAVID FERBER
Solicitor to the Commission

IRVING H. PICARD
Assistant General Counsel

MARGARET M. TOPPS
Attorney

Securities and Exchange Commission
Washington, D.C. 20549

MARVIN E. JACOB
Associate Administrator
New York Regional Office
Securities and Exchange Commission
26 Federal Plaza
New York, New York 10007

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE 1/

COUNTERSTATEMENT OF THE QUESTION ADDRESSED

By a consent decree in an action brought by the Securities and Exchange Commission, a publicly-held corporation agreed, as ancillary relief to a permanent injunction against further violations of antifraud provisions of the federal securities laws, to court appointment of its directors. In the light of subsequent events, it is now appropriate for the corporation's stockholders to elect its own directors. The question involved is whether the court-appointed directors should be permitted to seek to be elected as directors by the stockholders.

1/ As a party in the court below, the Commission is a party to this appeal. See East v. Crowds, 302 F.2d 645, 646-647 (C.A. 8, 1962).

COUNTERSTATEMENT OF THE CASE

This is an appeal from an order of the United States District Court for the Southern District of New York (per Stewart, J.), entered on November 22, 1977 (A. 500-501), 2/ which affirmed a special master's report (A. 445-471, 492-499). This appeal challenges that part of the order holding that members of the court-appointed board of directors for International Controls Corporation ("ICC"), or their nominees, subject to a subsequent determination by the special master that they are otherwise eligible, be permitted to stand for election to the board (A. 453-455). The appellants are nine stockholders of ICC, owning in the aggregate more than 160,000 shares (A. 24-39). By an order of the district court filed on December 20, 1977 (A. 502), appellants were permitted to intervene "for the purpose of participating in matters relating to the shareholders meeting of ICC" (A. 503).

The Commission instituted this action in the court below on November 27, 1972, by filing a complaint seeking to enjoin Robert L. Vesco, ICC, which was a corporation controlled by Mr. Vesco, and 40 other individual and corporate defendants from further violations, inter alia, of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5 (antifraud provisions) and Section 13 of that Act,

2/ Pages of the joint appendix filed in this appeal are referred to as "A. ____." References to documents filed in the court below, which are not in the joint appendix, are cited to the docket sheets, which are part of that appendix. Appellants' brief is referred to as "Br. ____."

15 U.S.C. 78m (reporting provision) (A. 111-112).^{3/} The Commission alleged that the defendants had been involved in a complex scheme to transfer to shell corporations controlled by Mr. Vesco investments held by ICC in IOS, Ltd., and related companies. ^{4/} In addition to injunctive relief, the Commission had sought, among other things, the appointment of a receiver for ICC (A. 112).

After some negotiation, ICC consented, on March 16, 1973, to the entry of a final judgment of permanent injunction against it (A. 11-12). The judgment permanently enjoined ICC from violating provisions of the Securities Exchange Act (A. 12-13) and provided, in lieu of the appointment of a receiver for ICC, for the appointment of a special counsel (A. 13) and of "a new interim independent board of directors * * * none of whom * * * [had] previously * * * served as a member of the board of International Controls" (A. 16). ^{5/} The judgment specifically provided as to the court-appointed

^{3/} The facts underlying the Commission's injunctive action have spawned a substantial amount of private litigation (Report of Investigation by Special Counsel, filed November 29, 1977 (A. 10), pp. 760-784, A-28 to 36). Aspects of certain of those cases have previously been before this Court. See Hogan & Hartson v. Butowsky, No. 77-7570 (Nov. 29, 1977); International Controls Corp. v. Vesco, 556 F.2d 665 (1977), certiorari denied, 46 U.S.L.W. 3425 (U.S. Jan. 9, 1978) (No. 77-666); International Controls Corp. v. Vesco, 535 F.2d 742 (1976); International Controls Corp. v. Vesco, 490 F.2d 1334, certiorari denied, 417 U.S. 932 (1974); Securities and Exchange Commission v. Stewart, 476 F.2d 755 (1973).

^{4/} See, e.g., International Controls Corp. v. Vesco, *supra*, 490 F.2d at 1339; Securities and Exchange Commission v. Stewart, *supra*, 476 F.2d at 756.

^{5/} The court appointed Charles S. Desmond, George D. Gould, John Mosler, Allen M. Shinn, and Joseph W. Weiner. Mr. Weiner, who died in January 1976, has not been replaced. (A. 224, 306; Report of Special Counsel filed on November 29, 1977 (A. 10), p. A-28.)

board that it was to

"hold office until further order of [the] Court upon application of plaintiff Commission and until the shareholders of International Controls have elected a new board of directors in compliance with the provisions of the Securities Exchange Act of 1934" (A. 16-17).

Since March, 1973, ICC has been managed by the court-appointed board of directors (A. 37, 187). On January 9, 1976, a petition to intervene and motion for an order directing that a meeting of ICC shareholders be held to elect a board of directors to replace the court-appointed board was filed on behalf of these appellants (A. 24-39). The hearing on that motion was adjourned at the request of ICC pending the disposition of litigation involving ICC shares controlled by Mr. Vesco (A. 67). 6/

The district court, on September 29, 1977, after two hearings (A. 343, 376) and after submissions by the parties, including this Commission (A. 371), entered an order (A. 436) which provided for a shareholders meeting to be held on April 25, 1978 (A. 437), and, as urged by the Commission (A. 371-372), for the appointment of a special master to prepare a plan for the conduct and supervision of that meeting (A. 437). The special master submitted proposals to the district court on October 27, 1977 (A. 445), and, after reviewing objections filed by the parties (A. 479-481, 482-488, 489-491), the special master submitted certain amendments on November 21, 1977 (A. 492).

6/ The events from the date of intervention until the district court's order appointing a special master to oversee the election of directors are set forth at A. 74, 107-144, 146-147, 154-162 and described in appellants' brief at pp. 6-13. For reasons discussed, infra, it is our view that those facts are not relevant to this appeal.

The special master's amended recommendations, which the district court adopted (A. 500), provide insofar as relevant to this appeal:

- (1) That ICC stockholders or the court-appointed board may propose nominees for election to the new board, subject to a determination by the special master of their eligibility (A. 453-454); 7/ and
- (2) That nominees to ICC's board may not expend corporate funds in connection with the election (A. 466-467).

ARGUMENT

THE DISTRICT COURT'S ORDER, WHICH PERMITS THE COURT-APPOINTED DIRECTORS OR THEIR NOMINEES TO SEEK ELECTION AT THE FORTHCOMING MEETING OF ICC STOCKHOLDERS, WAS NOT ERRONEOUS UNDER THE CIRCUMSTANCES OF THIS CASE.

Almost five years have elapsed since the entry, by consent, of the final judgment of permanent injunction against ICC, which, among other things, provided for the management of ICC by an independent, court-appointed board of directors. The settlement of the Commission action in this manner was an effort to avoid the harsh consequences that a receivership might have had (Report of Special Counsel, pp. 1-2) and to assure that Mr. Vesco and those affiliated with him not control or influence the corporate decisionmaking process (cf. A. 16). During the course of its stewardship, the court-appointed board has dealt with, and to a substantial degree resolved, many of ICC's financial and legal problems (A. 187-196, 209-210, 216-219; Report of Special Counsel, p. A-28

7/ All nominees were to complete a questionnaire (A. 454, 457-458) designed to assist the special master in determining whether a nominee should be disqualified because of an affiliation with the Vesco interests or for some other reason (A. 453, 455). The special master has been holding hearings in order to determine whether certain nominees should be declared ineligible as candidates.

to 36). However, the circumstances compelling this extraordinary interruption in the shareholders' control of ICC's management no longer exist, and ICC's shareholders are about to regain their voice with respect to corporate policies.

We are in substantial agreement with appellants' arguments set forth at pages 17-26 of their brief. Certainly, members of a court-appointed board of directors should not be able to use their position for their own advantage. It was with this in mind that the Commission recommended the appointment of a special master to conduct and supervise the election (A. 371-372) and the prohibition against the use of corporate funds by candidates for ICC's board of directors (A. 372).

We disagree, however, with appellants' suggestion that the court-appointed "directors have managed ICC's affairs" without being accountable for their actions (Br. at 25-26). There is no evidence of wrongdoing by the court-appointed directors in this record, and appellants complain of none (A. 96-97). 8/

8/ While it may be that the appointment of an interim board of directors, free "from liability (except for gross negligence)," may be an extraordinary remedy (Br. 19), that should have no bearing in this case where no misconduct has been charged. The provision in the final judgment, to which appellants refer, states:

"Each interim Director appointed by [the] Court * * * shall not be liable for any action taken or omitted to be taken by him or for any error in judgment made in good faith by him in his capacity as interim Director unless it shall be proved that he was grossly negligent in connection with such action, omission or judgments" (A. 17).

Nor has there been any showing that the special master's plan does not adequately protect the interests of ICC stockholders. In the absence of such a showing, as noted by the special master (A. 456), there is no reason to deprive those stockholders "of the opportunity to benefit from the experience and knowledge of ICC's affairs accumulated by the Court-appointed Board * * *." We agree with the special master that, absent some specific disqualification, stockholders should have "the opportunity to decide whether the election of the present Directors to the new Board is in their best interests" (id.).

Appellants urge (Br. 26-42) the adoption of a general rule that court-appointed directors in Commission enforcement actions not be permitted to run for election as directors by shareholders. In support of their argument, they rely in part (Br. 28-29) on the Commission's position taken in Protective Committee v. Anderson, 390 U.S. 414 (1968), that a reorganization trustee should be disqualified from assuming a significant position in a corporation reorganized under Chapter X of the Bankruptcy Act (11 U.S.C. 501, et seq.). 9/

The Protective Committee case arose under Chapter X, where Congress contemplated that a "disinterested trustee" 10/ would be the "focal point"

9/ The Supreme Court, in reversing orders which had approved and confirmed a Chapter X reorganization plan, pursuant to which the Chapter X trustee would have become president of the emerging corporation, found it unnecessary to pass on that question. See 390 U.S. at 423 and n.8.

10/ Sections 156 and 158 of Chapter X, 11 U.S.C. 556 and 558.

for the reorganization. 11/ A Chapter X trustee not only is charged with operating the debtor's business, but, as "the active head of the reorganization process," 12/ is responsible for "assembling the necessary ingredients" for the reorganization plan, if feasible, 13/ and for "prepar[ing] and fil[ing] a plan or a report of his reasons why a plan cannot be effected." 14/ The Commission argued in the Protective Committee case that a trustee seeking to formulate a plan pursuant to which he might become an executive of a reorganized company would not be disinterested. He might seek to curry the favor of a debtor's major creditors or outside sponsors of a plan who would be likely to control the reorganized company. It was suggested that such potential conflicts should be eliminated by a prophylactic rule.

No comparable need appears to exist as to court-appointed directors. Although responsible for the corporation's operations, they have no function comparable to effectuating a plan of reorganization. While there may be circumstances under which such persons should not be allowed to seek election as directors, there would normally be no conflict between steps they would take as directors for the benefit of the corporation and steps that would be likely to induce stockholders to vote for them. And in the instant case, the prohibition against court-appointed directors' use of corporate funds in their efforts to be elected and the appointment

11/ H. Rep. No. 1409, 75th Cong., 1st Sess. 44 (1937).

12/ Id.

13/ Id. at 43.

14/ Section 169 of Chapter X, 11 U.S.C. 569.

of a special master charged with assuring that the election is fair appear to provide ample safeguards against abuse.

Indeed, the special master currently is reviewing (cf. A. 470) the nominees' answers to a questionnaire "designed to assist * * * [him] in determining whether proposed nominees are eligible for election and to elicit information comparable to that required by Schedule 14A [of the Commission's proxy rules, 17 CFR 240.14a-101] * * *" (A. 457-458). Based on the information developed in this process, the special master may determine that members of the court-appointed board, or their nominees, should not be permitted to run in the election.

In the instant case, the court-appointed directors have been superintending the affairs of ICC during a period in which it has become profitable (A. 187-189, 191-196). We believe that the court below properly exercised its discretion in giving ICC shareholders the opportunity to determine for themselves whether they wish to continue all or some of these directors in office. That is a decision that should be made on the basis of the facts of a particular case, and there should be no absolute rule depriving shareholders of that opportunity.

CONCLUSION

For the foregoing reasons, the order under review should be affirmed.

Respectfully submitted,

DAVID FERBER
Solicitor to the Commission

IRVING H. PICARD
Assistant General Counsel

MARGARET M. TOPPS
Attorney

Securities and Exchange Commission
Washington, D. C. 20549

MARVIN E. JACOB
Associate Administrator
New York Regional Office
Securities and Exchange Commission
26 Federal Plaza
New York, New York 10007

January 1978

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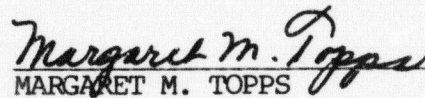
Intervenors-Appellants.

CERTIFICATE OF SERVICE

I certify that on January 23, 1978, I caused two copies of the BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE, to be served by mail, postage prepaid, upon the following:

Edward Brodsky, Esquire
Spengler, Carlson, Gubar,
Churchill & Brodsky
280 Park Avenue
New York, New York 10017
Counsel for Intervenors-Appellants

Sheldon D. Camhy, Esquire
Shea, Gould, Climenko & Casey
330 Madison Avenue
New York, New York 10017
Counsel for International
Controls Corp.


MARGARET M. TOPPS
Attorney

Securities and Exchange Commission
Washington, D. C. 20549